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DIRECTORATE OF
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Intelligence Memorandum

West Germany: The Deutschemark Problem--An Embarrassment of Strength

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
September 1968

INTELLIGENCE MEMORANDUM

West Germany: The Deutschemark Problem -- An Embarrassment of Strength

Summary

Record trade surpluses in West Germany and the weakness in the balance of payments of other major Western countries -- particularly the United States, the United Kingdom, and France -- have stimulated widespread rumors of an early upward revaluation of the Deutschemark. Large amounts of speculative capital have flowed into Germany in spite of the low interest rates there and the nearly unanimous opposition of West German government and business leaders to a revaluation. This massive speculation, if it continues, could ultimately force the Germans to revalue the mark.

The German opposition to a revaluation of the mark rests on the fact that the enormous recent trade surpluses are clearly related to the 1966-67 economic recession, the most severe of the postwar period, which cut the demand for imports while exports were continuing to grow rapidly. Germany is pulling out of the recession, but there is no immediate danger that the economy will soon become overheated. Revaluation at this time would impede domestic economic recovery and consequently might not reduce the trade surplus. And revaluation would reopen some complicated issues among European Economic Community (EEC) countries, especially in agricultural policy.

With Germany's economic recovery continuing, imports should grow more rapidly than exports and the trade surplus should shrink, although it will

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probably be more than another year before the current account is balanced. The German government has few ways left of stimulating imports directly and already has been following an easy money policy. It could, however, further boost the demand for imports through tax reduction or increased government spending; although anti-inflationary sentiment is strong, some inflation might be the only alternative to revaluation. Indeed, unless the German authorities are prepared to accept a fairly rapid rate of inflation, the Deutschemark could become undervalued relative to the currencies of major competitor countries, especially the United States, the United Kingdom, and France, where domestic inflationary pressures are strong.

Background

1. Speculation about a possible new upward revaluation of the Deutschemark in the range of perhaps 5 to 10 percent has been in the background of international financial discussions since the return of very large surpluses in West Germany's balance of trade. From a post-1961 revaluation* low of US $300 million in 1965, the West German trade surplus rose to $4.2 billion in 1967, and during the first eight months of 1968 it has continued at an annual rate of about $3.9 billion. Both the balance on current account and the basic balance (the combined balance on current and long-term capital accounts) registered record surpluses of $2.4 billion and $1.5 billion, respectively, in 1967. In contrast to the very healthy state of West Germany's foreign trade, UK trade thus far has been unable to capitalize significantly on the advantages from last November's 14.3 percent devaluation of sterling; French trade has been in deficit for a considerable period and can be expected to deteriorate further as import demand and export prices rise in the wake of the settlements caused by the May-June crisis [redacted] 25X6

This sharp contrast in trade performance has led many to believe that the Deutschemark is relatively undervalued. And because devaluation of any of the other major currencies could be expected to trigger competitive devaluations and would endanger the entire international monetary system, a unilateral revaluation of the mark would seem very much preferable.

2. Speculation came to a head just prior to German Minister of Economics Schiller's visit to London for discussions with his British counterpart Roy Jenkins. Despite official denials that a pending revaluation of the Deutschemark was one of the topics of conversation, international financial circles have acted on that assumption ever since, setting off a stampede to convert dollars and other Free World currencies into Deutschemarks. The flow of speculative capital to Germany reached about $1.5 billion

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* *On 6 March 1961 the international value of the Deutschemark was increased from 4.2 to 4.0 marks to the US dollar.*

during late August and early September.* It has since abated but could resume at any time. Unlike the flight from sterling and dollars into gold in late 1967 and early 1968, the recent flight into Deutschemarks is not so much a reflection of a current weakness of either sterling or dollars as a reflection of the strength of the Deutschemark and the anticipation of substantial short-run profits to be made from Deutschemark holdings if revaluation does in fact occur. Even those who consider a revaluation of the Deutschemark to be unlikely tend to view the mark as the major currency least likely to be devalued, and they are therefore willing to accept a lower rate of interest on their investments in Germany than elsewhere.

3. West German government, business, and labor leaders with near unanimity have adamantly rejected the demand for an appreciation of the Deutschemark, denying its economic necessity or justification and refuting its alleged virtues either as a cure for the balance-of-payments problems of the deficit countries, or for stabilizing the international monetary system. They dispute the argument that the German economy is in fundamental disequilibrium at the current rate of exchange and point out that the large trade surplus reflects cyclical rather than secular trends.

Recent Economic Activity and the Balance of Payments

4. There is no doubt that the large German trade surpluses of the past two years or so are primarily attributable to the economic recession in West Germany. Following two years of rapid growth in 1964 and 1965, inflationary pressures mounted. When the government proved unable or unwilling to employ fiscal restraints to counteract these pressures, the Bundesbank applied the monetary brake. As a result, economic activity in West Germany almost leveled off in 1966 and declined in 1967, the first absolute decline for a full year since World War II. Gross national product (GNP) in constant prices was only about 2 percent higher in 1967 than in 1965, and industrial production in 1967 was about at the 1965 level. Imports followed the trend in the domestic

* *This inflow of funds was not added to West Germany's reserves because of compensating short-term outflows by German commercial banks induced by Bundesbank policies.*

economy. They grew slightly in 1966 and fell sharply in 1967, to below the 1965 level. Meanwhile exports benefited from expansionary policies followed in many foreign countries; they grew by more than 20 percent during this period. The following tabulation compares changes in economic activity with those in imports and exports since 1965:

Annual Percentage Changes

	GNP				
	Current Prices	Constant Prices	Industrial Production	Imports	Exports
1965	+8.9	+5.1	+5.4	+19.5	+10.4
1966	+6.1	+2.4	+1.7	+ 3.2	+12.5
1967	+0.3	-0.5	-1.7	- 3.7	+ 7.9

As a result of these changes the trade balance rose from a small surplus in 1965 to a record surplus in 1967, which swamped the usual deficit on services and transfer accounts.

5. The German economy is well on the way to recovery from the 1966-67 recession. During the first half of this year, GNP was 7 percent higher than in the corresponding period of last year, which resulted in an increase of 13 percent in imports. But exports also grew rapidly, by 8 percent, so that the trade surplus for the period declined only slightly. The same trends in imports and exports continued in July and August. The following tabulation shows the trade balances (exports f.o.b., imports c.i.f.) for recent periods:

	Million US $
1965	+ 301
1966	+1,989
1967 (year)	+4,215
1967 (Jan-Aug)	+2,763
1968 (Jan-Aug)	+2,595

6. The large surpluses on current account since early 1967 have been partly offset by net outflows on capital account. These compensating capital movements were primarily in response to German easy money policies designed to stimulate domestic recovery and to minimize the adverse impact of the German surpluses on international liquidity. The staged reduction of

the Bundesbank's rediscount rate, from 5 percent in January 1967 to 3 percent in May 1967, and the simultaneous reduction in the minimum reserve requirements of the commercial banks had the effect of lowering long-term interest rates in Germany below the levels prevailing in the Euro-bond market and many other Free World capital markets. As a result of the recession-induced decline in investment demand and the decline in the long-term interest rate, 1967 saw a sharp reversal of Germany's traditional position as a major net importer of private investment capital. In contrast to a net inflow of private long-term capital of $422 million in 1966, Germany in 1967 recorded a net outflow of $546 million. The net outflow of official and private long-term capital combined in 1967 was nearly $900 million.

7. The fall in short-term interest rates opened a substantial gap compared with those on the Euro-dollar and other Western money markets. As a result, short-term capital movements in 1967 recorded a net outflow from Germany exceeding $1.1 billion, compared with a net inflow of $596 million in the preceding year. The combined outflow of long and short-term capital from Germany in 1967 thus totaled more than $2 billion, up from a mere $16 million in 1966. Capital outflows have thus largely offset the record $2.4 billion surplus on current account, limiting the increase in official German gold and foreign exchange reserves (after allowance for net errors and omissions) to only about $100 million in 1967. Key accounts in West German external payments show the following balances:

	Million US $		
	1965	1966	1967
Balance on current account	-1,607	+107	+2,414
Balance on capital account	+ 605	- 16	-2,046
Of which:			
Long-term capital, net	+ 235	-612	- 898
Short-term capital, net	+ 370	+596	-1,148
Change in gold and foreign exchange reserves	- 376	+258	+ 103

8. The outflow of long-term capital accelerated further in 1968, totaling $1,532 million for the first seven months of the year compared with less than $400 million during the corresponding period in 1967. However -- reflecting in part the unsettled international monetary situation in the wake of the gold crisis in March and the French disorders in May-June -- recorded short-term capital movements for 1968 through July showed a net inflow of $175 million. This was a sharp reversal from the net outflow of $1,360 million during the same period in 1967. With the surplus in the current balance at $1,430 million (only slightly below last year's January-July total of $1,450 million), official gold and foreign exchange reserves (which had declined $150 million during January-July 1967) increased by more than $700 million in the corresponding period of 1968.

Arguments Against a Revaluation

9. The 5 percent revaluation of the Deutschemark in 1961 has frequently been cited as a precedent for a new revaluation in the near future. As the German authorities are quick to point out, however, the situation today is very different from that of 1961. In 1961, Germany had been running consistently large surpluses in its balance of payments for several years. The German economy was near the peak of a business cycle and was experiencing strong inflationary pressures. Today the evidence does not indicate a basic imbalance in West Germany's foreign payments. The economy is at a relatively early stage of recovery from its most serious postwar recession. Moreover, West Germany has entered into many agreements with other EEC countries, especially in agriculture, that did not exist in 1961 and that could be upset by a revaluation.

The Basic Evidence

10. The evidence of a basic undervaluation of the Deutschemark is inconclusive or negative. The fact that Germany has run large balance-of-payments surpluses during a recession neither proves nor disproves the point. The problem must be viewed over a period long enough to average out the effects of cyclical movements. Over the seven-year period 1961-67, Germany had both surpluses and deficits in its current foreign account and in its basic balance (the balance on current and long-term capital accounts combined).

In the aggregate the surpluses were larger than the deficits, but not by a great deal. Over this seven-year period Germany earned smaller net surpluses than France or Italy, for example, and its accumulation of gold and foreign exchange reserves was smaller, as shown in the following tabulation:

Totals for 1961-67 (Million US $)	Current Balance	Basic Balance	Increase in Gold and Foreign Exchange Reserves
Germany	1,384	882	989
France	2,924	3,256	3,629
Italy	6,710	9,464	1,664

The surpluses of all these countries are largely the reflection of the deficits in the US balance of payments. In the seven years prior to the 1961 revaluation, Germany earned surpluses of $7.7 billion on current account and $5.4 billion in the basic balance, each about six times as large as in 1961-67. In the earlier seven-year period, moreover, Germany had accumulated $4.4 billion in reserves.

11. The strong performance of German exports, an average annual growth of more than 9 percent since 1961, is sometimes considered an indication of the undervaluation of the Deutschemark. But German performance, while far better than that of the United States or the United Kingdom, is inferior to that of several other countries, including Japan, Italy, and Belgium. The German share of the total exports of industrial countries increased only fractionally, from 15.3 percent in 1961 to 15.4 percent in 1966 and 15.8 percent in 1967. By way of comparison, the following tabulation shows the export shares of other major industrial countries in the total exports of all industrial countries in 1961 and 1967:

	Percent 1961	Percent 1967
United States	25.3	22.9
United Kingdom	13.3	10.4
Japan	5.1	7.6
France	8.7	8.3
Italy	5.0	6.3
Netherlands	5.2	5.3
Belgium	4.7	5.4

12. Despite these neutral or negative indicators, it is still possible that the Deutschemark may be undervalued. German costs may be below those in competing countries at prevailing exchange rates over a wide range of production, and the cost advantage may show up in higher profits rather than in the volume of export sales. Direct information on comparative costs and profits is scarce, and the problem is a highly complex one. But rough measures of changes in comparative costs do exist, and these are not favorable to West Germany. Data on changes in labor cost per unit of output (the ratio of indexes of wages per hour to indexes of output per hour in manufacturing) for 1967 indicate a larger increase in West Germany than in any major competing country since 1961, as shown in the following tabulation:

	Indexes for 1967 (1961 = 100)		
	Labor Earnings	Output per Man-Hour	Labor Earnings per Unit of Output
West Germany	158	132	120
France	150	137	110
United States	122	120	102
United Kingdom	126	122	103

The German competitive position in manufacturing costs appears to have worsened sharply during 1962-65. It has improved, however, since the onset of the recession in 1966.

The Cyclical Problem

13. Whether or not the Deutschemark is basically undervalued, current economic and financial conditions are far less favorable to a revaluation now than they were in 1961. In 1960-61 the German economy, after a period of exceptionally rapid growth, was experiencing increasing inflationary pressures. Both domestic and foreign demand for German goods was strong, profits were high, and unemployment was virtually nonexistent. The high liquidity of the banking system, fueled by repeated trade surpluses and the influx of foreign investment funds, had already weakened the effectiveness of the monetary restraints applied by the Bundesbank to control the boom. Under the circumstances, the massive flight of "hot" money into the German money markets raised the specter of runaway inflation.

Revaluation of the Deutschemark could, therefore, be justified as a useful anti-inflationary measure as well as a means of achieving a better long-term balance in foreign payments. The government was reasonably certain that its action would not be followed by changes in the parities of any of the other major currencies that would either intensify or neutralize the effectiveness of its revaluation. Moreover, given the comfortable profit margins then enjoyed by German industry and the continued strong domestic demand for its product, the government could be confident that revaluation would not seriously hurt German producers.

14. The situation in 1968, however, is much different. Domestic demand, though well ahead of the recession lows and above the pre-recession highs, is considerably below domestic production capacity. Exports account for a larger share of total sales in many branches of industry than ever before. Domestic prices have remained stable and wage increases have been moderate. Expanded growth, rather than the danger of renewed inflation, is now the primary concern of the government. An upward revaluation of the Deutschemark at the present time, the German authorities fear, would have a decidedly deflationary impact on the economy, tending to arrest expansion before full-capacity output is attained.

15. In these conditions, moreover, it is uncertain that the net effect of revaluation would be to reduce the balance-of-payments surplus. Revaluation would tend to slow the growth of exports by making German goods more expensive abroad. But in the short run at least, most German producers would maintain their export sales, absorbing the revaluation by taking lower unit profits. Their incentive to do this is all the stronger because of the continued lag in domestic demand. Faced with narrower profit margins on their exports, German producers probably would curtail their investment plans in export industries. And cuts in investments would add to the negative impact of the revaluation on German incomes.

16. To the extent that revaluation would reduce the sales and profits of German producers and induce a curtailment of investment plans, it would reduce aggregate demand, including the demand for imported goods. Under the circumstances, the stimulating effect of a reduction in prices on imports -- if

German importers did in fact pass their savings on to consumers -- might be weaker than the dampening effect of lower incomes on imports.

Other Complications

17. A revaluation would complicate West Germany's relations with other EEC countries, especially in agriculture. The agricultural sector could suffer severely if the Deutschemark were revalued. Its earnings are determined in large measure by the Common Agricultural Policy of the EEC, which sets uniform prices for the principal farm products. These prices are expressed in units of account per metric ton, based on the gold parity of the US dollar, and Deutschemark prices are derived from the Deutschemark-dollar parity -- that is, four Deutschemarks per dollar. Revaluation of the Deutschemark could result in a cut in the Deutschemark proceeds per unit of account, and as a result in German farm incomes. More likely, revaluation would unravel once again the very touchy question of the level of agricultural prices in the EEC. With surpluses of many farm products increasing throughout the EEC and pressures to reduce prices mounting, there is a strong likelihood that new prices agreed upon would be somewhat lower than the prevailing ones, again to the disadvantage of the high-cost West German agricultural producers.

18. The adverse effects of revaluation on the German economy would create an accumulation of serious political difficulties for the parties in power at the very time that they prepare to face the parliamentary elections scheduled for the fall of 1969. The continuing uncertainty in the international financial situation, aggravated most recently by the weakness of the franc in the aftermath of last spring's widespread disorders in France, also is a reason for the German opposition to revaluation. The German authorities must take into account the possibility that the franc may have to be devalued and the fact that sterling has not yet demonstrated its viability at the current rate of exchange. Thus, even if revaluation of the Deutschemark did not unduly harm West Germany's competitive position, there is a danger that subsequent devaluations of other currencies would leave the mark overvalued.

Prospects

19. Although German authorities almost unanimously reject revaluation, except as a measure of last resort, they cannot be certain of their ability to avoid it. Exports of long-term capital thus far have sufficed to offset Germany's large surplus on current account, and swaps* between the Bundesbank and German commercial banks have reversed much of the speculative inflow of short-term funds. Neither arrangement, however, provides more than a temporary solution; the swaps may not be sufficient to reverse the inflow of short-term funds if speculative pressures again begin to mount. Indeed, signs of further weakness in any of the other major currencies -- the dollar, sterling, or the French franc -- could set off a renewed flight into the Deutschemark.

20. The only lasting way of regaining a balance in foreign payments is to reduce the huge trade surplus. Current and prospective economic trends will tend to have this effect. The current upswing of the economy, triggered by extensive government pump-priming operations, has accelerated the growth of imports. If, as is likely, rapid economic recovery continues, imports will grow faster than exports and the surplus on commodity trade will shrink. The growth of exports should begin to slow down during the next few months unless fears of revaluation spur a wave of cautionary foreign buying. A considerable share of the 1968 surplus thus far is due to the extraordinarily large increase in exports to the United States and the United Kingdom (50 percent and 20 percent, respectively). US and UK import demand is likely to grow considerably more slowly during the remainder of the year.

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* *In periods of rapid accumulation of foreign exchange reserves, the Bundesbank's swaps with the commercial banks are employed to channel these reserves abroad into investment in foreign short-term securities. In these transactions, the Bundesbank sells foreign exchange to the commercial banks, at the same time undertaking to repurchase the funds later at a rate which in effect subsidizes the commercial banks, making the exchange transactions and investment of the funds abroad attractive to them. The amount of the "subsidy" is varied as a matter of Bundesbank policy, in response to (1) short-term interest rates abroad, and (2) exchange rate differentials in private foreign exchange markets.*

21. Meanwhile, imports should continue to grow rapidly. Particularly encouraging are the strong indications that consumer expenditures, whose expansion thus far has tended to lag substantially behind that of government and business spending, began to accelerate in the second quarter of 1968. Since imports of manufactured consumer goods (other than foodstuffs) declined especially sharply during the recession (13 percent compared with little more than 3 percent for all imports), the revival of consumer spending promises a more than proportional increase in imports. To support further expansion of private consumption expenditures, government spokesmen have openly acknowledged the desirability of higher wage settlements in industry. With the labor market tightening perceptibly -- there are now almost three vacancies for every person unemployed -- the growth of hourly industrial wages has in fact been rising rapidly, reaching 5.7 percent at an annual rate by midyear, up from an extremely low 2.3 percent last winter. Reflecting in part the acceleration of private consumption expenditures in recent months, the latest government projections for the economy have raised the rate of growth of private consumer spending for 1968 to about 5 percent, which suggests a higher rate of growth than that for the remainder of the year to compensate for lagging growth earlier. The anticipated rate of growth of fixed investment has been raised to 8 percent, while that for government consumption expenditures has been lowered slightly, from 4.7 to 4.4 percent. The overall rate of growth now expected for the GNP in 1968 is close to 7.5 percent in current prices (or more than 5.5 percent in real terms).

22. Despite the strong revival of aggregate domestic demand, Germany probably will end 1968 with another large, if reduced, foreign trade surplus. The autonomous forces currently active in the economy simply have not been in effect sufficiently long to close the gap. Indeed, if exports continue to grow at an annual rate of 7 to 8 percent while imports grow at 15 percent, it would take until 1970 for the trade surplus to shrink to the point that it would no longer cover the deficit on services and transfer payments. Consequently, to eliminate its balance-of-payments surplus, Germany will have to sustain an economic boom for another one to two years.

23. The scope for additional government action to accelerate the growth of imports directly through

a relaxation of remaining trade restrictions or indirectly through stimulating more rapid growth of aggregate demand is limited. Unilateral tariff reductions are no longer feasible since the elimination of tariffs on intra-EEC trade and the adoption of the Common External Tariff schedule binding on all EEC countries. A further easing of monetary policy would be to little avail in view of the fact that domestic money market rates are already very low and are substantially below those in other industrial countries. Expansionary fiscal policies would seem to offer the best opportunity for stimulating more rapid growth. The 1969 budget, designed to be neutral in its effect on the economy, foresees an increase in government expenditures of approximately 5.5 percent, considerably less than the forecast growth of GNP (in current prices). An increase in government expenditures, or, alternatively, a reduction in income tax rates, could give a substantial boost to aggregate demand, including the demand for imports.

24. While an increase in deficit financing in a period of relatively rapid economic growth and full employment runs counter to the government's long-term program for fiscal reform and is indeed anathema to conservative government leaders and to the banking community, it may be less damaging to the economy than a revaluation of the currency. As the economy approaches full capacity, inflationary forces will grow stronger and the German authorities will be tempted to apply the brakes. But, much as they may dislike inflation, in the end they may accept a considerable amount of it. With costs likely to rise fairly rapidly in most industrial countries -- especially in the United States and France, Germany's two largest trade partners -- the competitive position of German producers will improve unless their costs rise too. As a result, excessive trade surpluses could become chronic, and revaluation of the Deutschemark could become the only means available for restoring balance in Germany's foreign payments.